SeaBridge Investment Advisors, LLC

SeaBridge Asia Strategy

Third Quarter 2017
Commentary

Led by China, Asia's equity markets, like most emerging markets, turned in a strong performance during the quarter. The Shanghai composite continued its recent run posting strong gains in the period. The impressive market advance represents a significant turnaround in sentiment surrounding Chinese stocks. Recent strong economic performance has been the most important catalyst for Chinese market. Data from key areas of the economy including industrial production, retail sales, corporate profitability and exports have shown improvement in the quarter and exceeded expectations Chinese equities have long been weighed down by concerns over slowing growth and soaring debt levels. Money was leaving the country, legally or otherwise. Foreign currency reserves, though still healthy, breached the level of US$3 trillion in January of this year, a kind of psychological support level below which investor anxiety seems to set in. Capital flight forced a change to the exchange rate setting process. The peg to a basket of currencies was widened in 2015 to relieve the downward pressure. The yuan declined 9% vs. the U.S. dollar between October 2015 and December of last year. However, since December 2016, it has risen against the dollar by almost 5%, a respectable showing for a currency that had become the focal point for short sellers seeking to profit from China's inevitable collapse. Or so was the thinking.

Readers of our commentaries know that we were never in the China bashing camp. We tried as best we could to show that slowing growth need not be feared, believing that the quality of growth would improve as the country rebalanced toward a more consumption-oriented economy. We believed that currency flight would abate as short-term dollar obligations were repaid. China's exports disappointed in 2015 and 2016, but have rebounded this year. Over the past decade, we have been constantly reminded by naysayers of the property bubble, the off-balance sheet financing schemes, the bridges to nowhere, the corruption, the phony accounting. We do not deny the existence of China's excesses. We simply believe that China's obituary has been written many times since the financial crisis of 2008 and that rumors of its death, like Mark Twain's, as the writer himself noted, have been grossly exaggerated. You can find a comprehensive assessment compiled by SeaBridge on the current state of affairs in China by visiting www.SeaBridge.com and clicking Commentary → SeaBridge 2017 Interim Commentary → May Presentation.

Later this month, the 19th National Congress will convene in Beijing. At these meetings, which occur every five years, the policy agendas for various ministries are established. Leadership knows that the world is watching. Some would argue that Chinese market performance is a contrivance, a buffing up the silverware before the party begins. There may be some of that going on in the stock market. But, in addition to a better economy, we think that investors are beginning to appreciate the progress that the country has made on a number of reform initiatives that will no doubt be featured at the October meeting. Below we name a few:

1. **Deleveraging.** The total non-financial sector debt which includes government, household, and corporate debt is the most intractable problem facing the country. As a percent of GDP, these levels have sharply increased from less than 150% at the onset of the financial crisis in 2008 to roughly 250% at the end of 2016. China has taken some steps to rein in credit creation. The central government wants local governments to replace high cost borrowings from banks and shadow banks with low cost municipal bonds. There has already been progress on this front. According to CLSA, by July 2017, Rmb9.52 trillion

(US$1.4 trillion) of high cost local government debt has been swapped for low yielding bonds. China knows that the public bond markets need to be expanded with foreigners invited to participate. The public markets should be more rational allocators of capital than state owned banks. In addition to the public fixed income markets, we believe that more bankruptcies are part of the solution to China's debt problem especially among inefficient state-owned enterprises. There has also been some progress on this front as well. According to CNBC, Chinese courts accepted 5,665 bankruptcy cases in 2016, an increase of 54 per cent from the year before. About 3,600 of those cases were resolved, with 85 percent of the resolved cases resulting in liquidation.

2. **Supply Side Reform**. This initiative is a close cousin of deleveraging. If funds are choked off from state-owned enterprises, then needless production of goods from this sector would abate. Other supply side reform should occur through administrative decree. Since 2015, China has cut its steel capacity by 13% and coal by 10% simply by demanding that state-owned companies operating in these industries produce less.
3. **Mixed Ownership**. This is a reform element that again targets the state-owned system. The idea here is to introduce private capital with its own set of demands on how a company should be run into companies now entirely controlled by the state. According to Reuters, China completed 48 deals valued at a rather paltry US$1.6 billion. Because these numbers must increase significantly to make a difference, we are skeptical on the mixed ownership plan.
4. **Consumer Oriented, Innovation Driven Economic Growth**. Increasing the minimum wage steadily and often dramatically over the past few years certainly has helped to produce the marginal wealth necessary to drive consumption. In addition, China's housing policy, derided in the West because of easy credit provided to developers, has also undoubtedly helped stimulate consumption. China's wealth effect comes out of housing. To date, Tier 1 and Tier 2 cities have been the biggest beneficiaries. Now, the migration out of substandard housing has extended to lower tier cities. Local governments have become less focused on the developer and more on inhabitants, allocating cash directly to home buyers to assist with their purchase. It is a way to pare down the inventory of housing which because of its sheer size has made headlines in the West. The central government is involved in the scheme providing some level of financing to local governments. We expect more such initiatives to come out of the Congress.

China is not the only story in Asia. There are many positive things happening around the region. We thought we'd comment on one of our best performers in the portfolio this quarter noting the favorable business environment in which the company operates.

Amata Corporation is a company that develops industrial estates for manufacturers in Thailand. The company owns prime real estate in the Southeast close to ports and with the infrastructure in place to support manufacturing and shipment of product. Prospects for the company have dramatically improved because of something known as the Eastern Economic Development Corridor project, a government sponsored undertaking. Thailand hopes to develop its eastern provinces into a leading ASEAN economic zone. The government expects to spend US$43 billion for the realization of the EEC over the next five years primarily on the continuing buildout of infrastructure. Provisions include:

- The exemption for corporate income taxation (CIT) for up to 15 years instead of the current maximal tax holidays of eight years,
- A maximum personal income tax (PIT) rate of 17%,
- A five-years business visa,
- A land lease for 50+49 years,
- Trade using foreign currencies directly without having to exchange it into Thai baht,
- A 3-month public-private-partnership (PPP) procedure, and
- A fast-tracked environmental impact assessment (EIA).

There will be some populist push back on the plan, but Thailand is clearly heading in a pro-business direction.

This is just one example of governmental initiatives we are seeing in the region, designed to help companies thrive. Embroiled as the U.S. is now in a debate over individual and corporate taxes and immigration, perhaps there is something to be learned by examining the pro-business policies of our Asian counterparts.

We've have had a nice run in Asian markets. Can it continue? We think the answer is yes, with caveats. The Asia investment case is a long-term story. There is no better justification for our commitment to the region than its superior demographics, which can be summed up by the following statement: *According to a Brookings Institution forecast, of the 2.4 billion people expected to enter the middle class between 2015 and 2030, 2.1 billion will come from Asia. Of the US$29 trillion of incremental consumption this new middle-class group represents, US$24.3 trillion will be spent by Asians.*

There are two main risks to the generally favorable outlook we have for the region. We are not so naïve as to believe that Asia on its own has been responsible for the success of its markets this year. Loose monetary policy is undoubtedly a tailwind for the region. Central banks will almost certainly tighten monetary policy in the coming months and years. The ultra-easy money policy that all major central banks have enacted since the Great Recession must be unwound. How this is accomplished will bear greatly on the investment environment everywhere, but the withdrawal of accommodation will be magnified in the emerging world including Asia. If interest rates rise too rapidly or spreads blow out, volatility will likely increase and our optimism about the region may at times be tested.

The second risk, of course, is North Korea. On this subject, we have no greater insight than what is currently being analyzed and debated in the media. We'd like to think that there is too much at risk for the U.S. to intervene militarily. We may be wrong. Let's hope that cooler heads prevail and a diplomatic solution found.

We've included, as is customary in our mailing, an addendum highlighting portfolio activity in the period.

Dave Descalzi
October 9, 2017

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Transaction Summary

Note: not all of the transactions mentioned here apply to all accounts due to client-specific factors.

Purchases

We initiated a position in **Aerospace Industrial Development Corporation**, a Taiwan-based company engaged in the manufacture of aircraft and engines for both commercial and military customers. It also provides aircraft and avionic maintenance services, flight services, information services and technology services. The Company distributes its products within domestic and to overseas markets.

We like the company primarily because it has been de-rated. It is experiencing some growing pains as it builds out its plant footprint in anticipation of strong order flow from Boeing and Airbus. Because of its pedigree and success as a defense contractor, the company will likely always have a base level of business from the Taiwanese government. Beyond Taiwan, defense budgets are fast expanding in Asia and the company should be a beneficiary of this upswing. Additionally, we believe it will also be an increasingly large supplier to private global aircraft OEM's. There is a long runway to this company. Pardon the pun.

We expect the stock to perform in 2018 as its free cash flow generating capability becomes more obvious. The balance sheet is a little stretched now, but free cash should help over the next two to three years. We think it can be a mid-teens EPS grower in one to two years. It trades at about 13x next year's earnings. We think the upside/downside to the stock favors the upside.

We added to our position in **Keppel Reit**, which owns grade A office property in Singapore. Reported earnings in Asia on KREIT's Q2 results were slightly below market expectations and the share price declined slightly. We took advantage of an extremely modest pullback in the share price to buy more shares. The investment case for KREIT is simply that we think the recession in office property in Singapore is over and that we should begin to see upward rent revisions and increased occupancy in Grade A office space. KREIT should be a beneficiary of the trend; dividends should increase in the quarters and years ahead. NAV should improve.

We added to **Standard Chartered,** which reported a decent set of results for the half year ending June 2017. Operating income was up 9% driven by strength in China and North Asia. Trade-related finance and wealth management were important product drivers. Net income rose by 93% with fewer provisions taken on an improving loan portfolio as the bank continues its restructuring. Despite clear evidence of a turnaround at the firm which had been plagued by missteps in the emerging markets, the stock declined because investors were disappointed that a dividend was not declared. Despite a healthy CET1 ratio, the company wants dry powder for fines that may be levied for possible money laundering violations that occurred in prior years involving Iran. We are not bothered by this dividend deferral. We think it prudent. The company is heading in the right direction and should be helped by global synchronous growth.

Sales

We trimmed our stake in **Venture Corp**. which had an impressive run in the quarter. The company is benefitting from strong demand in its testing and measurement/life science division. Among the customer base are Illumina, Agilent, Danaher, and Keysight. Venture's success in this division is driven by its competency as a contract manufacturer that goes beyond just assembly but includes some design capability that helps the OEM's. Its products are part of the feedback loop of data collecting, testing and measuring the effectiveness of processes and products and the improvement of those processes and products for its customers. Obviously, this is part of the powerful secular trend that starts with data and ends with better, smarter products. In September, the CEO bought 400,000 shares for total consideration of US$4.5 million. In July, he purchased 200,000 shares on the open market. He now owns more than 7% of the company. Although we think the company is executing well on its plan to migrate up the value-added production chain, we thought it prudent to trim our over-sized position.

SM Prime is a multi-line property company involved in residential construction and sales, retail mall construction and operation, hotels, and convention centers in the Philippines. It also has modest holdings in China. Before the restructuring of its parent, SM Investment, to include all property operations under one corporate umbrella, SM Prime had a narrower retail mandate. It became the largest mall operator in the Philippines. We thought correctly that malls in the Philippines function more as entertainment venues for the locals, with retail a beneficiary of the foot traffic. Philippine malls have largely escaped the traffic declines we have seen in U.S. malls. Furthermore, the restructuring has benefitted the company. The most recent development, a collaboration between the company and the Pasay and Paranaque municipal governments to develop Manila Bay frontage for residential and mixed use purposes, should be a huge windfall for the company. The stock has been up strongly as terms of the deal have been publicized.

We thought it prudent to trim. Analysts' forecasts may be too optimistic. The stock has risen on optimism surrounding Pasay and Paranaque projects. This is now a high P/E stock in a country that is run by a very volatile, unpredictable leader.

We eliminated our long-held position in **Giant Manufacturing**, the world's largest bicycle manufacturer, based in Taiwan. We are very concerned that the bike sharing phenomenon in China will create a demand void for new bicycles in China, a very important market for Giant. Best to go to the sidelines and wait to see how the bike market in China will be affected by bike sharing.

We trimmed our large holdings in **Tencent** (China; gaming, social media, bill payment), **China Lodging** (China; hotels) and **Wharf** (Hong Kong; property investment company) on strength.

David Descalzi
10/9/17

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